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Supreme Court of the United States.

October Term, 1940.

Haffenreffer Brewing Company
v.
Commissioner of Internal Revenue.

Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the First Circuit
and
Brief in Support Thereof.

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Supreme Court of the United States.

OCTOBER TERM, 1940.

HAFFENREFFER BREWING COMPANY
v.
COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT.

To the Honorable the Chief Justice and Associate Justices of the Supreme Court of the United States.

Haffenreffer Brewing Company prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the First Circuit entered in the above-entitled case on December 23, 1940.

Jurisdiction.

The judgment below was entered December 23, 1940. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

By Section 351 of the Revenue Act of 1934 a surtax in the nature of a penalty was imposed on the "undistributed adjusted net income" of a personal holding company as

therein defined. In determining "undistributed adjusted net income" the law provided that there should be deducted "amounts used or set aside to retire indebtedness incurred prior to January 1, 1934."

This case presents the following questions of construction:

1. Must the indebtedness be evidenced by "a bond, note, debenture, certificate of indebtedness, mortgage or deed of trust . . ."?

2. Where the taxpayer corporation by written contract executed August 1, 1930, agrees to pay a certain percentage of its earnings in each year to retire its preferred stock, and the earnings in 1933 are such that it thereby becomes obligated to set aside and pay the sum of $86,400, and this sum is actually so paid and applied in 1934, is this amount "used or set aside to retire indebtedness incurred prior to January 1, 1934"?

Statement of Facts.

On June 27, 1930, the two stockholders of two corporations engaged in the brewing business entered into an agreement to form a corporation to acquire all the capital stock of these corporations, and a claim for moneys loaned by one of the stockholders to one of the corporations. The petitioner in this case was organized pursuant to this contract under the laws of Massachusetts, issued its preferred and common stock in exchange for the capital stock of the other corporations and for the said claim (R. p. 25). The petitioner also became a party to and adopted the said contract of June 27, 1930, on August 1, 1930 (R. pp. 9, 29). By the terms of said contract and by the provisions of the preferred stock issued in accordance with said contract, it was agreed that the petitioner should set aside in each year

a certain percentage of the net earnings of the corporation for such year as a sinking fund, and that the petitioner "shall have the right to and shall apply the sinking fund to the redemption of preferred shares at the par value thereof and accumulated dividends, or to the purchase of preferred stock at not to exceed the par value thereof and accumulated dividends . . ." (R. p. 27). The contract defined at length the manner in which net earnings were to be determined (R. p. 20).

During 1933 consolidated net earnings as defined in the by-laws of petitioner were such that the petitioner was required by the contract to which it became a party on August 1, 1930, and by the provisions of its preferred stock which was issued on August 1, 1930, to set aside the sum of $86,451.67 as a sinking fund for the purchase or redemption of its preferred stock (R. p. 29).

Early in 1934 the petitioner applied $86,400 for the retirement of the preferred stock in accordance with the provisions of the contract and the terms of its preferred shares (R. p. 29).

The Board of Tax Appeals, three members dissenting, held that this sum of $86,400 was not deductible, and this decision was affirmed by the United States Circuit Court of Appeals for the First Circuit, but on grounds different from those upon which the Board of Tax Appeals based its decision.

The grounds on which the Court below relied were in substance as follows:

1. Section 27 (a) (4) of the Revenue Act of 1938, relating to corporation dividends paid credit, provides:

> "As used in this paragraph the term 'indebtedness' means only an indebtedness of the corporation existing at the close of business on December 31, 1937, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the cor-

poration and in existence at the close of business on December 31, 1937, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date. . . ."

The Court below held that by analogy this definition governed the meaning of the word "indebtedness" as used in the provisions relating to surtax on personal holding companies.

2. The Court further held that payments by a corporation to retire preferred stock are not payments on account of an indebtedness, even if prior to January 1, 1934, the corporation incurred a fixed and absolute obligation to pay a definite sum of money to retire or purchase stock.

Reasons Relied on for the Allowance of the Writ.

1. The decision in this case is in conflict with the decision by the Circuit Court of Appeals for the Third Circuit in the case of *Commissioner* v. *Tennessee Co.*, 111 F. (2d) 678.

The Court below in the instant case attempts to distinguish the Tennessee case on the ground that that case dealt with promissory notes. The material portions of the instrument involved in the Tennessee case are set forth on page 6 of the brief attached to this petition, and it is respectfully submitted that it is clear beyond any doubt that the instrument involved in the Tennessee case was not a promissory note and did not in any material respect vary from the instrument involved in the instant case. True, the instrument in the Tennessee case was shrewdly or unwittingly miscalled a "promissory note," but the recent decisions of this Court lend no room for an argument that malapropism, deliberate or otherwise, is any sufficient basis for distinction in legal results.

2. The decision is in conflict with the great mass of decisions in the Federal Courts and in the Supreme Judicial Courts of Massachusetts to the effect that the relationship between a corporation and stockholder is transformed into a debtor-creditor relationship where by contract, vote to redeem, or the occurrence of any other contingency a corporation becomes subject to a fixed, definite or absolute obligation to pay a definite sum of money to purchase or retire preferred stock. Under such circumstances it is settled law that the obligation of the corporation with respect to such stock becomes an indebtedness just as it would if the stock were in form converted into bonds.

The authorities on this point are cited on page 9 of the brief attached to this petition.

3. The contention of the Court below that the indebtedness must be evidenced by a note or similar written instrument is not only in conflict with *Commissioner* v. *Tennessee Co.*, 111 F. (2d) 678, but with the plain language of the statute, the applicable regulations and a number of decisions of the United States Board of Tax Appeals.

4. The questions involved in this case are questions of general and continuing interest and importance.

Wherefore it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the First Circuit should be granted.

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PETITIONER'S

BRIEF

BRIEF IN SUPPORT OF FOREGOING PETITION.

Opinions Below.

The Opinion of the Board of Tax Appeals is reported in 41 B.T.A. 443, and is printed on pages 30-41 of the Record. The Opinion of the Circuit Court of Appeals is reported in 116 F. (2d) 467, and is printed on pages 50-63 of the Record.

Jurisdiction.

Reference is made to the foregoing petition for a statement of the jurisdiction of this Court and the statement of the case.

Argument.

In *Commissioner* v. *Tennessee Co.*, 111 F. (2d) 678, a corporation in 1933 executed an instrument the material portions of which are as follows:

> "*Promissory Note*
>
> The Tennessee Company . . . promises to pay to . . . the principal sum of . . . Dollars. . . . The payment of the principal of and interest of this note . . . shall be made only out of net earnings of the Company as hereinafter defined determined by the Board of Directors of the Company to be available for that purpose. 'Net Earnings' applicable to the payment of the principal of and interest on this note shall be the amount remaining after deducting from gross earnings and income of the Company from all sources for the fiscal year all expenses and charges for operation, taxes, interest, losses, depreciation, amortization and all reserves for any of the above purposes, and such

other reserves as may in the absolute discretion of the Board of Directors of the Company be determined to be expedient in the proper management of the business of the Company."

The Circuit Court of Appeals for the Third Circuit held that the amounts paid in 1934 on the above instrument out of the earnings of that year were deductible as payments on an indebtedness incurred prior to January 1, 1934.

As Judge Clark pointed out, the instrument was payable "when, as and if those earnings came into existence, and not otherwise . . ." An instrument is not a promissory note, negotiable or non-negotiable, unless it contains an absolute promise to pay a fixed sum of money at a definite time. This instrument was not a promissory note.

Uniform Negotiable Instruments Law, § 184, Mass. G.L. (Ter. Ed.) c. 107, § 207.
Coolidge v. *Ruggles,* 15 Mass. 387.
Sloan v. *McCarthy,* 124 Mass. 245.

"A note is not in legal effect the same as an ordinary contractual obligation to pay the amount named therein, even if non-negotiable."

Burdett v. *Walsh,* 235 Mass. 153, 155.

No substantial distinction can be found between the rights and liabilities incident to the security involved in the Tennessee case and those of the preferred stock involved in the case at bar; both securities were preferred stock, to which was attached a collateral contract which, on the occurrence of certain contingencies, transformed the obligation represented by the stock to an obligation of a debtor to a creditor.

Thus in *Commissioner* v. *Schmoll Fils Associated, Inc.*, 110 F. (2d) 611 (2 C.C.A.), a security, the incidents of which were quite similar to the security involved in the Tennessee case, was held to be preferred stock, although called by the parties "debentures"; and conversely in *Commissioner of Internal Revenue* v. *Palmer, Stacy-Merrill, Inc.*, 111 F. (2d) 809, a security called "preferred stock" was held to be an indebtedness because of a fixed obligation to redeem in installments.

In the absence of earnings, for example, a payment on the instrument clearly would have been a voluntary payment and not on account of an indebtedness. When, however, earnings accrued, a definite obligation did arise, and the decision in the Tennessee Company case is a decision that an amount paid in discharge of this obligation is deductible if the obligation resulted from a contract executed prior to January 1, 1934.

The case at bar is a far stronger case in favor of the taxpayer than the Tennessee case. Here the taxpayer agreed in substance to pay to its preferred stockholder a sum equal to a fixed percentage of its 1933 earnings. This obligation became fixed and absolute and was "incurred" in 1933, whereas in the Tennessee case the obligation did not become fixed and absolute until 1934.

United States v. *Anderson*, 269 U.S. 422, 441.

A decision in favor of the taxpayer in the Tennessee case is therefore wholly inconsistent with a decision adverse to the taxpayer in the instant case, although the reverse may not necessarily follow.

As stated by the Board of Tax Appeals in its opinion (R. p. 35), the petitioner's contention is "that regardless of whether the preferred stock as such was an indebtedness of the petitioner to the extent of its par value, the *obligation* of the petitioner under the terms of the contract to use

$86,451.67 of the 1933 consolidated net earnings in retirement of part of its preferred stock was an 'indebtedness incurred prior to January 1, 1934'."

In other words, while the relationship between a corporation and a preferred stockholder is not a debtor-creditor relationship, it may be transformed into a debtor-creditor relationship by a vote to redeem, or by a contract to purchase or by the occurrence of any contingency which creates a fixed obligation to redeem stock.

In *Pier* v. *Commissioner,* 96 F. (2d) 642, 651, Judge Haney said:

> "I think that upon notice of acceptance of the option, the preferred stockholders became creditors. . . . Upon declaration of a dividend by a corporation, the stockholder becomes a creditor. . . . I do not believe that, because it is left to the directors to fix the date of redemption, there is any distinction, *since once the date is fixed, the relation is the same.*" (Italics supplied.)

To the same effect see:

> *Scriggins* v. *Thomas Dalby Co.,* 290 Mass. 414.
> *Dustin* v. *Randall Faichney Corp. et al.,* 263 Mass. 99.
> *Crimmins & Pierce Co.* v. *Kidder Peabody Acceptance Corp.,* 282 Mass. 367, 376.

In an analogous situation the Court, in *Commissioner* v. *Proctor Shop,* 82 F. (2d) 792, said:

> "The controlling feature is the existence of the obligation, not its source."

Of course, it does not follow that any personal holding company may at any time create an indebtedness to be used

as a deduction by voting to redeem stock, since Section 351 of the Revenue Act of 1934 requires that the transformation from stock to indebtedness take place prior to January 1, 1934. There is nothing, however, in Section 351 which excludes from its remedial provisions any indebtedness arising before January 1, 1934, merely because the indebtedness arose out of stock of the corporation. There seems no rational distinction between a corporation whose preferred stock was converted into bonds prior to January 1, 1934, and a corporation which by vote or ordinary contract incurred an obligation to purchase stock, at least when this obligation became fixed and absolute before January 1, 1934.

Thus the inchoate right of stockholders to earnings is not an indebtedness, but may be transformed into an indebtedness by a declaration of a dividend, and if the dividend is not paid when due, interest accruing on the dividend thereafter is deductible as interest on an indebtedness.

> *Commissioner* v. *T. R. Miller Mill Co.*, 102 F. (2d) 599.

Thus the Regulations (Art. 23 (b) (1), Reg. 101) allow interest paid on script dividends as a deduction of interest on an indebtedness.

Prior to the decision in the instant case the Government had abandoned any contention that "indebtedness" as used in the provisions of the 1934 and subsequent acts imposing a surtax on personal holding companies was confined to indebtedness evidenced by any particular form of instruments.

See *American Foundation Co.* v. *Commissioner*, 40 B.T.A. 542, where the Board of Tax Appeals in its opinion noted this change in the position of the Government, and held that a debt evidenced by a judgment was an "indebtedness" within the meaning of the law.

Again, the Board of Tax Appeals has recently held in *Floyd, Inc.*, v. *Commissioner*, 43 B.T.A. No. 16, promulgated December 18, 1940, that an obligation for taxes was an "indebtedness."

Finally, the regulations applicable to the surtax on personal holding companies do not require that the obligation be evidenced by a promissory note or similar instrument, and otherwise differ substantially from the regulations promulgated in connection with the provisions relating to dividend credits contained in Section 27 (a) (4) of the Revenue Act of 1938.

For the foregoing reasons it is respectfully submitted that this petition for writ of certiorari should be granted.

Respectfully submitted,

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